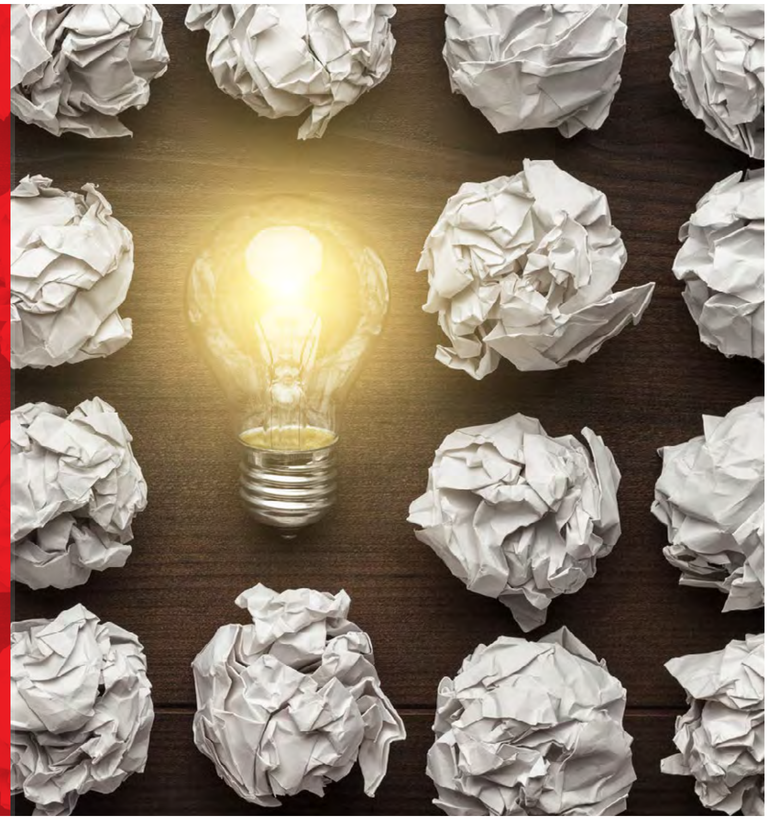
LexisNexis®
Lexis Practice Advisor®

TOP 10 PRACTICE TIPS: MEDIUM-TERM NOTES



by Edward S. Best, Mayer Brown LLP

This practice note outlines ten practice points for internal and external counsel to consider before establishing a medium-term note (MTN) program and when issuing MTNs. An MTN program enables an issuer to more efficiently offer and sell debt securities, which may have similar or different terms, on a periodic or continuous basis by using pre-agreed offering and underwriting documents and a simplified clearing process. While MTN programs are often used by finance companies, especially auto finance companies, that have continuous financing needs, they are a useful and common tool for any company looking to raise capital.

1. CONFIRM THAT ISSUING SECURITIES THROUGH AN MTN PROGRAM MAKES SENSE GIVEN THE ISSUER'S FINANCING NEEDS

Before establishing an MTN program, an issuer should evaluate whether the incremental costs of an MTN program, as compared to discreet offerings, make sense given the issuer's financing objectives. Establishing an MTN program involves the drafting of a lengthy prospectus supplement or offering memorandum describing in detail the terms that can be included in the MTNs, including the base rates for floating rate notes (and how they are calculated), currency, indexing, extension, reset and amortization provisions, as well as the tax implications of these terms. All of this involves costs for options that most issuers never access. Furthermore, periodic deliveries and due diligence involve ongoing costs that may not provide incremental benefit to issuers financing infrequently. Conversely, an MTN provides substantial benefits to an issuer financing on a relatively frequent basis (e.g., three or more times per year) or that wishes to be able to issue on very short notice.

2. UNDERSTAND THE COSTS AND PROCESS FOR PERIODIC DOCUMENT DELIVERY AND DUE DILIGENCE

The earliest MTN programs (the first MTN program was established by General Motors Acceptance Corporation in the late 1970s) were used by finance companies to match fund their assets with liabilities and were thus structured to allow for frequent (often weekly or even daily) issuances. To avoid the cost and delay associated with providing legal opinions, comfort letters and other closing deliveries on a frequent basis, MTN programs typically provide for quarterly deliveries of comfort letters, legal opinions and officers' certificates at or around the time an issuer's quarterly financial statements are issued. In addition, due diligence is ideally completed on a quarterly basis at or around the same time. By conducting due diligence and delivering due diligence related documents on a quarterly basis, an issuer can ideally avoid having to provide such documents with each offering thus allowing quicker and cheaper access to the market. This process works best for an issuer issuing relatively small amounts of securities on a frequent or regular basis.

In practice, however, most issuers issue securities in a smaller number of larger transactions. Where a significant issuance is effected more than a short period of time after delivery of the quarterly deliverables, many investment banks will require some sort of bringdown comfort letter and/or legal opinions as well as bringdown due diligence. In that case, an issuer has to decide whether there is any benefit in providing quarterly deliverable if it has to provide essentially the same documents off cycle. Some less frequent issuers that use an MTN program either time their issuances to coincide with the delivery of quarterly deliverables or suspend the MTN program (and thus the requirement to provide quarterly deliverables) until they are ready to issue and then provide required comfort letters, opinions and other closing documents.

3. BE PREPARED TO INCLUDE ADDITIONAL AGENTS FOR SPECIFIC ISSUANCES THROUGH DEALER-FOR-A-DAY AGREEMENTS

When an MTN program is established, the issuer typically appoints a small number of investment banks to act as agents for the program. These agents are disclosed in the prospectus supplement for the program and sign the distribution or selling agency agreement with the issuer. However, when the issuer decides to issue securities, it may want to include in the offering banks with which it has close commercial relationships but which are not parties to the distribution agreement. In that case, the issuer will execute with each additional bank a dealer-for-a-day agreement, the form of which is typically included as an exhibit to the distribution agreement.

Pursuant to the dealer-for-a-day agreement, the issuer appoints the investment bank as an agent for the specific issuance and the new agent becomes entitled to the benefits (e.g., representations and warranties, indemnities, etc.) of the distribution agreement. The new agent will typically also receive copies of previously delivered comfort letters and opinions with letters allowing it to rely on the previously delivered letters or opinions or newly issued comfort letters and/or opinions specifically addressed to it. Because dealers-for-a-day are typically invited into the offering after the launch and, unlike co-managers in corporate bond offering, will need to sign the dealer-for-a-day agreement prior to pricing, agents' counsel should have the form of agreement and copies or drafts of comfort letters and opinions available to be provided promptly after launch.

Where an issuer consistently includes certain banks as dealers-for-a-day, the issuer might consider having the banks sign an accession letter becoming dealers on the program or including the banks in the program next time the issuer updates or refreshes the program.

4. MONITOR THE AMOUNT AVAILABLE FOR ISSUANCE

Some MTN prospectus supplements specify an amount that can be issued under the program. This practice was necessary before the Securities and Exchange Commission (SEC) allowed pay-as-you-go registration for well-known seasoned issuers (WKSIs). Now, many MTN prospectus supplements do not specify a limit. However, where there is a limit in the prospectus supplement, either because the issuer is not a WKSI or because the issuer or its board chooses to have a limit, counsel should monitor the amount authorized and issued. In addition, counsel should make sure that the issuer understands that the limit is on the amount originally issued and not, as with commercial paper, the amount outstanding at any time. Also important to monitor is the amount authorized under the issuer's board resolutions. It is not uncommon for an issuer's board of directors to authorize the establishment of a multi-billion dollar program but reserve the right to authorize specific issuances on a case-by-case basis.

5. UNDERSTAND THAT NOT ALL MTN PROGRAMS ARE THE SAME

MTNs are typically offered in different ways and the documentation and process for each is typically different. Classically, an issuer would post rates or spreads over Treasury securities for a range of maturities through its agents. The rates posted would change periodically based on how much or little the issuer was looking to issue. When an investor was interested in investing, the particular agent would confirm the details with the issuer and arrange for the issuance. In this type of offering, a pricing supplement would not typically be prepared and delivered until the details of the issuance were confirmed and, because the purchaser was solicited on a best efforts basis, a terms agreement would not typically be used.

In a larger, syndicated underwritten offering, the offering might be launched with a preliminary pricing supplement (much like a preliminary prospectus supplement for a corporate bond offering). When the offering is priced, a free writing prospectus term sheet will be circulated. Where a preliminary pricing supplement is used, it may be just as easy to skip the free writing prospectus term sheet and just use the final pricing supplement to confirm sales. If the offering is underwritten, a terms agreement will typically be signed and dealer-for-a-day agreements may also be signed.

In a reverse inquiry, an investor may approach an issuer either directly or through an investment bank (which may or may not be an agent on the MTN program) with the terms of a specific MTN in which it is looking to invest, even where the issuer is not posting rates. If the issuer is interested in raising funds and can agree on terms with the investor, the issuer will prepare a final pricing supplement. If the introducing bank is an agent on the issuer's MTN program, no additional documentation may be necessary. If the introducing bank is not an agent on the issuer's MTN program, a dealer-for-a-day agreement will need to be signed and the introducing dealer will need to agree with the issuer whether it will require any comfort letters, opinions or due diligence.

6. RETAIL MTNs ARE TYPICALLY AN ADJUNCT TO AN ISSUER'S OTHER FUNDING PROGRAMS AND HAVE SOME UNIQUE FEATURES

Some issuers have specific MTN programs marketed to retail investors through broker-dealers as an adjunct to their other funding programs. In a typical retail MTN program, an issuer will file a preliminary pricing supplement specifying the maturities and interest rates of the MTNs it is offering but without specifying any principal amount. Its agents then distribute the pricing supplement to their clients and through other retail broker-dealers with which they have relationships. At the end of the marketing period (typically a week or two), the lead agent will aggregate all of the orders received during the marketing period and the issuer will file a final pricing supplement with the principal amount of each maturity that it will issue. This process will then repeat for subsequent marketing periods.

Because an issuer can't know how receptive the market will be to the rates it posts and because retail MTNs are typically issued in small amounts (often less than $10 million per maturity), it typically won't rely on the retail MTN program as a major source of its funding. However, retail MTNs are not as rate sensitive as corporate bonds and even during turbulent market periods can offer an additional source of funding for companies needing to raise funds.

Because retail MTNs are issued on a weekly or bi-weekly basis, it is important to put in place appropriate procedures to ensure that pricing supplements are prepared on a timely basis and that there is good coordination between the issuer, the lead agent and the trustee to ensure timely issuance.

Retail MTNs are typically only issued as fixed rate, non-redeemable MTNs. One unique feature of retail MTNs is a provision, often called a survivor's option, permitting the optional repayment of the MTNs if requested by the authorized representative of the beneficial owner, following the death of the beneficial owner, so long as the MTNs were owned by the beneficial owner or his or her estate at least six months prior to the request. This feature allows a surviving spouse or executor to monetize an otherwise non-marketable retail MTN to pay for funeral costs or estate taxes. The survivor's option is often subject to a maximum amount per note and/or an aggregate annual maximum for all retail MTNs.

As with any other types of continuously offered products, issuers with retail MTN programs need to consider how their quarterly earnings blackout periods and other one-time blackouts affect their programs. It is often the case that issuers suspend their retail MTN programs during their quarterly earnings blackouts and then recommence when their Forms 10-K or 10-Q is filed and the associated comfort letters, opinions and officers' certificates are delivered.

7. NON-SEC REPORTING COMPANIES CAN STILL ISSUE MTNs

While most MTN programs (and all retail MTN programs) are registered with the SEC, non-SEC reporting companies can still issue MTNs either to qualified institutional buyers pursuant to SEC Rule 144A, in offshore transactions pursuant to a global MTN (GMTN) programme or, if the issuer is a bank or the U.S. branch or agency of a foreign bank, pursuant to a bank note program exempt from Securities Act registration requirements under Section 3(a)(2) of the Securities Act of 1933, as amended (the Securities Act).

A Rule 144A MTN program is similar in many respects to a registered MTN program. Where the issuer is not a public reporting company, the most significant difference is that the offering memorandum does not incorporate the issuer's publicly filed reports (unless the issuer is a reporting company in a foreign country and publishes English language reports). Practically, this means that the offering memorandum must contain a description of the issuer's business, the issuer's financial statements and management's discussion and analysis of the issuer's financial condition and results of operations. The issuer in a Rule 144A MTN program must also prepare a quarterly supplement to the offering memorandum with its most recent financial statements and MD&A and an annual update to the supplement. Where the issuer is a public reporting issuer in another country (e.g., it files reports in Canada on the Canadian Securities Administrators SEDAR system), the agents and counsel may be comfortable incorporating by reference those publicly filed documents.

A GMTN programme allows an issuer to issue MTNs in Europe and other non-U.S. jurisdictions. GMTNs are typically listed on a European exchange and the securities or banking authority of the country of the listing exchange acts as the competent authority under the European Union's prospectus directive for purposes of reviewing and approving the base prospectus. A GMTN programme base prospectus is typically much more detailed than its U.S. equivalent. Many GMTN programmes provide for sales into the United States under Rule 144A. Offerings under Rule 144A can be made with the form of "final terms" (which is the MTN equivalent of a pricing supplement) included in the GMTN base prospectus or with a short supplemental offering memorandum that wraps around the GMTN prospectus. Notes offered pursuant to Rule 144A are usually not listed.

In a bank note program, the issuing bank typically incorporates by reference the quarterly call reports it files with federal banking authorities. However, because bank call reports are prepared for supervisory and regulatory purposes and are not comparable to financial statements prepared in accordance with generally acceptable accounting principles, bank note offering memoranda typically also incorporate by reference the SEC reports of the parent bank holding company, especially where the issuing bank represents a significant majority of the bank holding company's assets, revenue and income. Banks do not typically issue retail MTNs for a number of reasons including the less expensive alternative of issuing retail certificates of deposit and the fact that national banks are subject to the registration requirements of Office of the Comptroller of the Currency in connection with retail issuances of securities (even where they are exempt under federal securities laws).

8. THE DTC CLOSING PROCESS FOR MTNS IS DIFFER-ENT FOR MTNs THAN FOR CORPORATE BONDS

MTNs, like virtually all corporate bonds, are issued in book-entry only form meaning that the MTNs are issued in the form of one or more global securities registered in the name of a nominee for The Depository Trust Company (DTC) and beneficial interest are held through participants in DTC. Unlike corporate bonds, MTNs settle through DTC's money market instrument (MMI) system. DTC's MMI system has three significant differences from its corporate bond system. First, the issuer must deliver to DTC an MMI letter of representations that is different than the standard letter of representations or blanket letter of representations for corporate bonds.

Second, upon establishment of the MTN program, the issuer or the trustee obtains a series of 900 CUSIP numbers from the CUSIP Bureau for the program. MTN CUSIPs also differ from corporate CUSIPs in that MTN CUSIPs typically begin with five numbers and a letter that identify the issuer whereas corporate CUSIPs typically begin with six numbers that identify the issuer. For an issuer with both types of CUSIPs, the first five numbers of the base CUSIP will typically be the same.

Finally, and perhaps most important, MTNs are settled on a delivery-vs-payment basis where delivery of the MTNs and the payment for the MTNs are made through DTC, with the trustee (as the DTC counterparty) receiving the funds and having to subsequently forward the funds to the issuer. Because DTC does not settle trades until as late as 2:00 p.m., the issuer is not guaranteed to receive the funds the same day of the closing. In the case of a corporate bond, settlement is made on a delivery-vs-free basis where the funds are wired directly to the issuer and the bonds are delivered through DTC. If the issuer wants to receive a wire transfer at closing, the same MTN documentation can still be used but before the launch of the offering the underwriter responsible for billing and delivery should be instructed to apply for a corporate CUSIP and the bill and deliver underwriter and trustee should be instructed to set up the issue to settle through DTC on a delivery-vs-free basis.

9. UNDERSTAND THE CONSEQUENCES OF MTNs BEING OFFERED ON A BEST EFFORTS BASIS

In order to avoid having to hold capital against a firm commitment to underwrite an issuer's MTNs, MTN programs are typically established with the investment banks acting as agents and agreeing to use their best efforts (or some similar standard) to solicit purchases of MTNs when and if requested by the issuer. It should be noted that while the investment banks may be acting as agents, they may still be considered underwriters for liability purposes under the Securities Act.

While acting on a best efforts basis is usually sufficient in connection with continuous offerings of small amounts of securities, issuers looking to raise a significant amount of funds may prefer to have the investment banks underwrite the offering or even syndicate the offering. In such cases, the issuer and the banks will typically sign a short terms agreement that incorporates the terms of the distribution or selling agency agreement and pursuant to which the banks agree to underwrite the MTN offerings.

One consequence of the banks acting as agents is that they are not entitled to a comfort letter under PCAOB Auditing Standard 634 (AU634) unless they provide an opinion stating that they have a due diligence defense under Section 11 of the Securities Act (an opinion that the agents may be deemed to be underwriters or have liability substantially equivalent to that of an underwriter under the securities laws would not meet this requirement) or a representation that the bank's due diligence in connection with the MTN program is substantially consistent with the due diligence they would have performed had the program been an underwritten registered offering under the Securities Act.

10. MAKE SURE THE TERMS ARE CURRENT AND DON'T JUST COPY FROM THE LAST DEAL

The prospectus supplement for an MTN program typically includes a fairly detailed description of the securities that can be issued, including descriptions of various base rates for floating rate notes and how those base rates are calculated. Counsel should make sure when the prospectus supplement is drafted or updated that these descriptions reflect changes in market practice and changes in facts. For example, references to Reuters or Bloomberg screens or pages should be confirmed as well as references to disclosures in Federal Reserve publications. Developments with respect to how benchmarks are calculated, especially LIBOR and EURIBOR, should be monitored and relevant disclosure, including risk factors, should be updated, including in the pricing supplement if appropriate.